

California Department of Consumer Affairs

Legal Guide U-2

RULES PROHIBITING LOTTERIES (California Penal Code section 319 and following)

September 1996

California law prohibits lotteries. A lottery is any scheme for the disposition of property by chance among persons who have paid or promised to pay any value for the chance of obtaining the property, with the understanding that it will be disposed of by chance.¹ The name by which the scheme is known is immaterial.

There are three elements which must be present in order for a scheme to constitute a lottery. There must be (1) a prize, (2) consideration, and (3) distribution of the prize by chance.² For a scheme to be a lottery, all three elements must be present.

California courts have interpreted these elements broadly. The courts have found a "prize" to include almost any kind of property, such as money, a trip, personal property or an automobile.³ In one case, the prize was money which could be obtained only if the participant successfully progressed through the scheme's several phases.⁴ The prize in another case was the right to play a free game.⁵

The second element of a lottery is the payment of consideration by the participant in order to be eligible to win a prize. "Consideration" may be any kind of value. The courts have found consideration where participants paid \$.25 in exchange for a Bingo card or for small plastic rings used to play a part of a game which was a lottery,⁶ and where participants paid \$1.00 in exchange for a short subscription to a bulletin and a ticket for a drawing.⁷ Even an empty beverage container, when deposited in a reverse vending machine, has been found to be consideration.⁸

Because it is not always clear whether a scheme includes the consideration element, the courts have declared rules for deciding whether consideration is present. In order for consideration not to be present in a scheme, the courts have declared that anyone must be eligible to win a prize without making any purchase. In such a scheme, if some

people may pay money -- for example, solely as an admission charge or solely for a product -- consideration is not necessarily present. However, if eligibility to win a prize is limited to those who have paid money -- for example, to make a purchase, or for a ticket or as an admission charge to an event or an establishment -- consideration is considered to be present. Finally, if some persons must pay in order to have a chance at a prize while others do not, consideration is considered to be present.⁹

The final element of a lottery is distribution of the prize "by chance." The chance element can be present in a scheme even if it contains elements of skill, as long as chance is the dominant factor in determining the outcome.¹⁰ Thus, bridge is a game of skill, although there is an element of chance resulting from the deal of the cards.¹¹ Bingo, on the other hand, is a game of chance.¹²

There are two major exceptions to the law prohibiting lotteries. The operation of the California State Lottery is authorized by the California Constitution. The Constitution also empowers the Legislature to authorize cities and counties to provide for bingo games, but only for charitable purposes.¹³

Example of a Lottery

Assume that a chain of stores conducts a promotion in which \$50 worth of merchandise is given to several customers each week. In order to be eligible to win the prize, a customer must write his or her name and telephone number on the back of one or more of the chain's cash register receipts, and deposit the receipt in a box at one of the chain's stores. Several receipts are drawn by each store at random each week, and the winners are notified by telephone. In addition, each store awards prizes randomly each week to two people who walk into the store.

This scheme is a lottery and is therefore unlawful under Penal Code section 319. The prize and distribution-by-chance elements clearly are present. Since not all persons are eligible to win a prize, and since, in order to be eligible to win a prize, a person must make a purchase, consideration is present in the scheme. The consideration element is not removed from the scheme by allowing some people to have a chance at a prize without paying.

Endless Chain Schemes

A pyramid sales scheme (called an "endless chain scheme" in California) also may be a lottery. An "endless chain" is a plan for distributing property under which a participant pays valuable consideration for the chance to receive compensation for getting one or more additional persons to participate in the plan, or for the chance to receive compensation when one of those additional persons introduces a new participant. (The term "compensation" does not include payment based on sales to an ultimate consumer whose purchase is not made in order to participate in the plan.)

The law prohibits endless chain schemes which fit this definition.¹⁴ California courts reviewing endless chain schemes have concluded that they are inherently deceptive. The reason is that the rewards promised by the scheme can only accrue to any level of participants in the pyramid if it grows to another level. Obviously, the point ultimately will be reached where the necessary further recruitment is impossible.¹⁵

A scheme that is an endless chain often contains the three elements of a lottery. An endless chain scheme typically awards a participant cash or product bonuses or rebates based on his or her sales volume and on the sales volume of participants below him or her in the pyramid. Such an award satisfies the "prize" element in the definition of a lottery. Such an award based on sales to a non-participating ultimate consumer also would satisfy this element of the definition.

Endless chain schemes typically require participants to purchase products or memberships, or to make financial commitments in order to be eligible for bonuses or rebates. Such a purchase satisfies the "consideration" element in the definition of a lottery.

Finally, a scheme that is an endless chain typically distributes the prize "by chance," as that term is defined in the lottery context. In an endless chain, chance is the dominating factor because a participant's success depends in major part on the activities of the scheme's promoters¹⁶ and the activities of those below the participant in the chain.¹⁷ Further, the success of a participant in an endless chain also depends in major part on the saturation of the market which occurs as the pyramid expands, which typically is not within the participant's control.¹⁸

Example of an endless chain scheme that is a lottery: A company markets its products through a hierarchy of salespeople called consultants. A person enters the program and becomes a consultant by being sponsored by another consultant, and by paying \$25 to the company for registration. Each consultant is encouraged to purchase a sample inventory of products from his or her sponsoring consultant, but the company literature says that a consultant is not required to make any purchase. Nonetheless, company policy encourages the purchase of the sample inventory and payment of the registration fee as a package, and a consultant cannot earn commissions without purchasing inventory.

The company encourages consultants to recruit others

and to sell its products to the recruits, who in turn are encouraged to recruit others and to sell the company's products to them, through three "generations." Retail sales also may occur. The consultant can purchase products for resale only from his or her sponsoring consultant, who has purchased the products from the company. The company encourages all consultants to purchase products in advance of need.

The consultant earns commissions on his or her own sales and on the sales of the consultants in his or her network, who must purchase their products from him or her. The consultant also receives rebates on the products purchased from the sponsoring consultant based on the total sales volume of the consultant's network.

The consultant can earn promotions to consultant 2 and consultant 3 by achieving specified sales volumes by his network and specified volumes of purchases for resale to his network. Consultant 2's and 3's receive increased commissions, greater rebates on products purchased, and bonuses, all of which are determined by sales and purchase volumes.

This scheme is both an endless chain and a lottery. It is an endless chain because the consultant pays consideration for the chance to introduce additional consultants into the scheme and to receive compensation from their sales. The scheme also depends on an endless chain of middlemen (new consultants), encourages inventory purchases by consultants at all levels, and does not emphasize retail sales. (The latter are other features of endless chain schemes which have been identified by California courts.)¹⁹

This scheme is also a lottery. The prize element is present in the form of commissions, rebates, and bonuses. The consideration element is present because participants must purchase products in order to receive the commissions, rebates, and bonuses. The element of distribution by chance is present in that a participant's success depends in major part on the activities of the scheme's promoters, the activities of those below the participant in the chain, and also on the saturation of the market as the chain expands.

Penalties and Enforcement

Any person who prepares or operates a lottery, furnishes lottery tickets, or assists a lottery is guilty of a misdemeanor.²⁰ Any property offered for distribution through a lottery is subject to summary attachment and is

forfeited to the State.²¹ Any person who prepares, proposes, or operates an endless chain scheme which fits the definition given above is guilty of a public offense punishable by imprisonment in county jail or state prison.²²

Misdemeanor provisions also prohibit any person from selling any share or interest in any lottery, or any share or interest which depends on the event of any lottery; from receiving valuable consideration upon an agreement to repay any sum or to deliver any property if any lottery ticket or number in any lottery wins or loses; and, from promising to pay any sum or to deliver any property upon any contingency which depends on the drawing of any ticket in any lottery.²³

The forfeiture and misdemeanor provisions are enforceable by the Attorney General or by any district attorney. The lottery and endless chain provisions also may be enforced through civil court actions filed by private parties, district attorneys, the Attorney General, certain city attorneys, and agencies of the state.²⁴ Depending on the nature of the civil action, remedies include civil penalties of up to \$2,500 for each violation, injunction, and restitution.²⁵ If the lottery includes false or misleading statements, remedies may include an additional civil penalty of up to \$2,500 for each violation.²⁶

A participant in an endless chain scheme may rescind (revoke) his or her contract with the scheme, and may recover payments made under the scheme (less payments received from the scheme).²⁷

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NOTICE: The Department of Consumer Affairs strives to make its legal guides accurate in every respect. However, this legal guide is only a guideline, and is not a definitive statement of the law. Questions about the law's application to specific circumstances should be directed to an attorney.

ENDNOTES

1. Penal Code section 319.

2. E.g., California Gasoline Retailers v. Regal Petroleum of Fresno, Inc. (1958) 50 Cal.2d 844 [330 P.2d 778]; Western Telcon v. California State Lottery (1996) 13 Cal.4th 475 [53 Cal.Rptr.2d 812, 816].
3. E.g., Regal Petroleum; People v. Cardas (1933) 137 Cal.App.Supp. 788 [28 P.2d 99]; People v. Gonzales (1944) 62 Cal.App.2d 274 [144 P.2d 605].
On the distinctions between a "prize" in a lottery and a "wager" in a game of chance, see Western Telcon v. California State Lottery (1996) 13 Cal.4th 475 [53 Cal.Rptr.2d 812].
4. People v. Shira (1976) 62 Cal.App.3d 442 [133 Cal.Rptr. 94].
5. People v. Settles (1938) 29 Cal.App.2d (Supp.) 781 [78 P.2d 274].
6. People v. Shira.
7. Holmes v. Saunders (1952) 114 Cal.App.2d 389 [250 P.2d 269].
8. 64 Ops. Atty. Gen. 629 (1981). Penal Code section 319.5, enacted subsequent to the Attorney General's opinion, states that the deposit of an empty beverage container in a reverse vending machine does not constitute "consideration."
9. People v. Shira.
10. People v. Shira.
11. In re Allen (1962) 59 Cal.2d 5 [27 Cal.Rptr. 168].
12. People v. Shira.
13. California Constitution, Article IV, section 19; see Penal Code section 326.5.
14. Penal Code section 327.
15. People v. Bestline Products, Inc. (1976) 61 Cal.App.3d 879, 911, 914 [132 Cal.Rptr. 767]. See Webster v. Omnitrition (9th Cir. 1996) 79 F.3d 776, 784 ("Pyramid schemes are destined to collapse, and the most recent entrants to lose their money.")
16. Cf. Webster v. Omnitrition (9th Cir. 1996) 79 F.3d 776, 783 ("The [scheme's] promoters provided the 'essential managerial efforts which affect[ed] the failure or success of the enterprise.'")
17. Cf. Finster v. Keller (1971) 18 Cal.App.3d 836 [96 Cal.Rptr. 241].
18. Securities and Exchange Commission v. Glenn W. Turner Enterprises, Inc. (D. Or. 1972) 438 F.Supp. 766, aff'd (9th Cir. 1973) 474 F.2d 476.
19. People v. Bestline Products, Inc.; Bounds v. Figurettes, Inc. (1982) 135 Cal.App.3d 1 [185 Cal.Rptr. 480]. See Webster v. Omnitrition (9th Cir. 1996) 79 F.3d 776, 787 (payment of compensation to participants based on product sales to their "downlines" is prohibited by Penal Code § 327).
20. Penal Code sections 319, 322, 323, 326.
21. Penal Code section 325.
22. Penal Code section 327.
23. Penal Code sections 321, 324.
24. Business and Professions Code sections 17200, 17204, 17206.
25. Business and Professions Code sections 17203, 17206; Civil Code section 1689.2.
26. Business and Professions Code section 17500. See People v. Bestline Products Inc. (1976) 61 Cal.App.3d 879 [132 Cal.Rptr. 767, 789-790] (the operation and promotion of an endless chain scheme within the meaning of Penal Code § 327 is an inherently deceptive marketing practice and is actionable under Business and Professions Code § 17500).
27. Civil Code section 1689.2.

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